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Serving Traders Responsibly

A GUIDE TO STRATEGIC FOREX TRADING

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INTRODUCTION

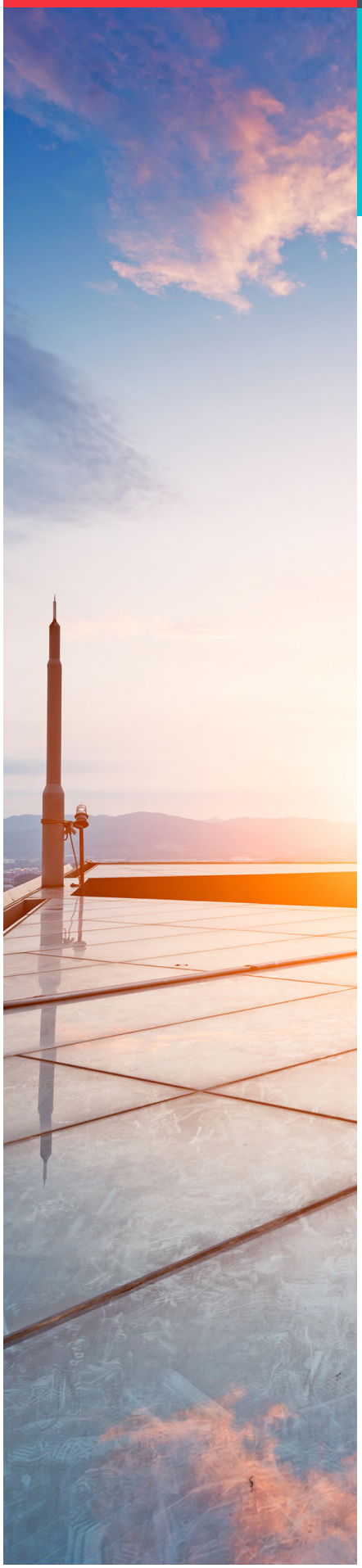
Trading currencies in the forex market does not have to be as difficult as one might have been led to believe. A solid, well defined trading strategy can make the process much easier on the trader if they are familiar with it and comfortable using it in a disciplined manner.

The key feature of a good forex trading strategy is that it allows a trader to operate effectively and profitably. Forex traders might focus on using just one strategy or they might employ a variety of strategies that involve watching different aspects of the forex market.

For example, a trading strategy could limit the trader to operating at certain highly liquid and active times of the day, such as day trading. Alternatively, it could involve quickly taken near term profits and losses, as in a scalping strategy, or establishing long term strategic positions, as in trend trading. Other strategies - like momentum and swing trading - involves following trends but also watching for over-extended markets, while news and hedge trading involves positioning around key economic data releases.

Most traders active in the forex market use one or a combination of the above mentioned strategies to trade profitably. They will each be described in greater detail below.

Some of the more sophisticated forex trading strategies, such as triangular arbitrage and the carry trade, are generally utilized by professional traders and financial institutions that have an edge due to their direct market access, large size and deep pockets. Such strategies lie outside the scope of this report.



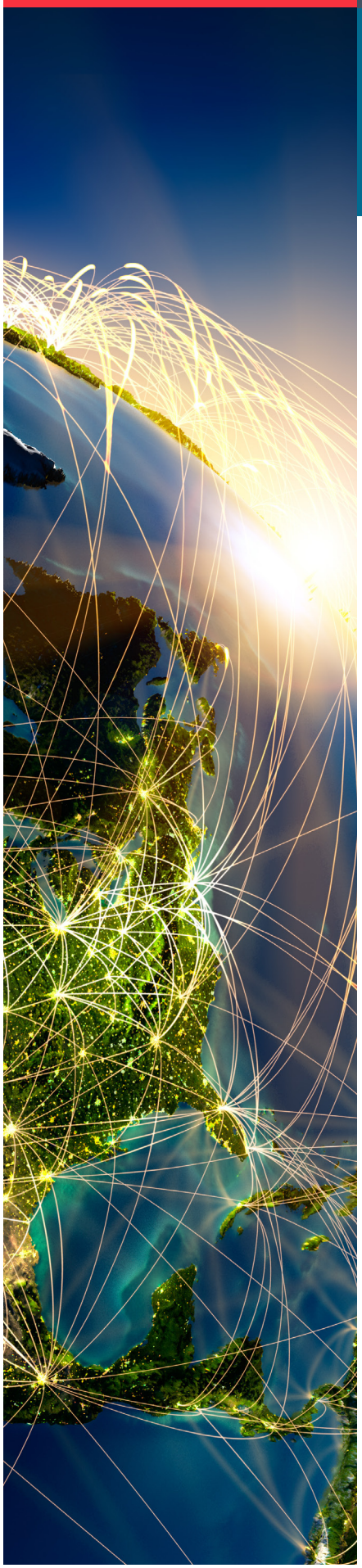
THE DAY TRADING STRATEGY

Day trading can best be described as a strategy involving the buying and selling of currencies during a specified time period, generally during a particular time zone's regular business hours. Because the forex market is open 24 hours a day for most of the week, a trader can limit their trading to the most advantageous time for them to be active in the market or during normal business hours for their particular time zone.
The basic and most important rule of day trading is that the trader closes out all positions at the end of the particular period or day set aside for their forex trading activity. While a day trader may have a number of other trading rules specific to their trading style, the one rule all day traders share is the closing out of positions at the end of their trading day.

Like other strategies, day trading involves a trader taking positions in currency pairs hoping to make a profit. If the trade does not go as planned, they should end up closing out losing positions before the loss becomes excessive. Generally, the day trader aims to take in small profits that can add up considerably during the course of the day or trading period, while at the same time minimizing their losses.

The most obvious advantage of day trading in the forex market is that the day trader is generally able to get a good night's rest by not taking on riskier overnight positions. Avoiding overnight exposure also saves the day trader from paying wider nighttime trading spreads. They also avoid paying the tom/next points incurred by overnight rollover swaps, which must be paid away at the end of business at 5.00PM New York time, if they are long the lower interest rate currency. A credit might accrue if they are long the higher interest rate currency.

While day trading is a viable trading strategy for many experienced forex traders, novice traders could find day trading to be somewhat challenging and stressful. Without a well defined trading plan and the discipline to adhere to its rules, the novice trader might easily be overwhelmed by the stress of intra-day trading. They might also stumble into a number of common trading pitfalls, such as



THE SCALPING STRATEGY

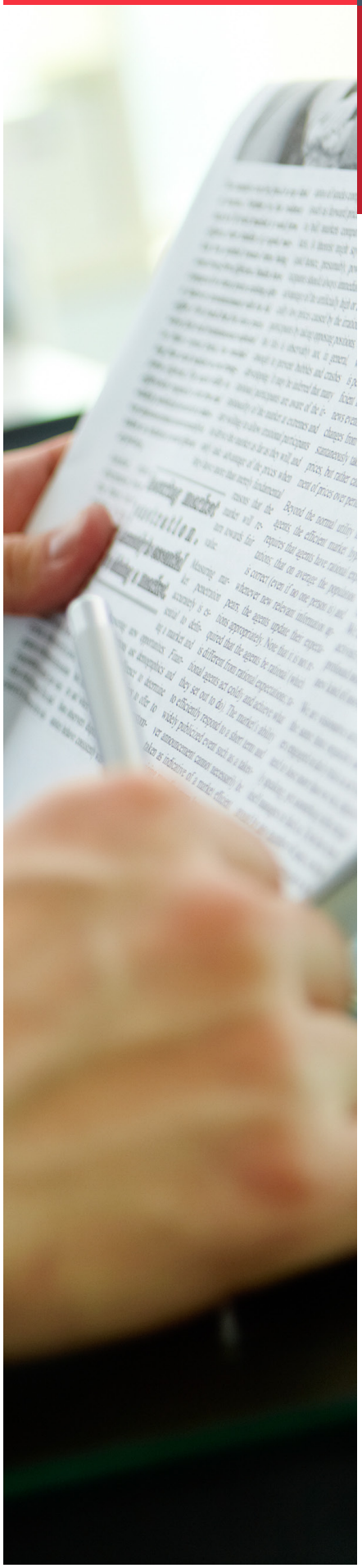
This popular trading strategy is used within a day trading framework and consists of taking advantage of the bid/offer spread in the currency market by attempting to buy near the bid side and sell near the offers side. The scalping technique is similar to one used by forex trading professionals and market makers that quote exchange rates for a bank or financial institution's clientele.

The main difference is that the smaller sized scalper usually does not make a two sided market. This allows the scalper to take a position which agrees with their general view of the market. They will then typically place a sell order just above the bid or a buy order just below the offer to quickly liquidate their position at a profit. Scalpers usually hold a position for a very short time, getting in and out of a trade within minutes if not seconds and taking just a few pips profit at a time.

The short intervals between trades and the speed of the scalper working with price differentials makes the trader have less exposure to risk overall. Additionally, if the trader is very disciplined about cutting their losses on losing trades, their risk is reduced even further.

Another advantage of scalping is how scalpers are able to take advantage of smaller differentials in market spreads that allow the scalper to make money even in quiet markets, where a talented scalper can leverage themselves to take on larger positions to make bigger gains. Basically, in order for a scalper to make a significant amount of profit, a larger position size is usually required to make the trade worthwhile.

Nevertheless, the forex market can be an unforgiving place if the scalper is caught in a losing trade in a fast market as they get continuous re-quotes from their forex broker while their position goes increasingly against them. Therefore, scalpers must be extremely careful to avoid high volatility when trading in the forex market and to have a reliable broker that offers minimal re-quotes.



NEWS TRADING ON ECONOMIC RELEASES

A trading strategy that appeals to many short term forex traders consists of trading around significant forex news events, such as key economic releases from the countries whose national currencies that make up the major currency pairs. The release of important economic data that could affect currency valuations creates high volatility in the forex market, especially if the result diverges significantly from the consensus of market analysts' expectations.

Because of the strong influence on a currency's valuation, a forex trader can take advantage of an important news release to make a significant amount of money. Nevertheless, a considerable familiarity with forex market fundamentals and a well funded forex account is strongly advised for this risky type of trading.

Getting caught in a currency position on the wrong side of an economic release can be extremely capital intensive, especially for an underfunded account that could easily result in a forced closeout. While riding out the volatility could be an option, a forex account without an appropriate funding cushion would not be able to absorb the loss while the market reacts.

Economic releases from the United States tend to carry considerable weight in the forex market due to the Greenback's status as a reserve currency and its role in every major currency pair. Key U.S. numbers - such as Non-Farm Payrolls, Gross Domestic Product and Retail Sales - make up just a few of the data releases that tend to move the forex market, especially when the numbers vary considerably from expectations.

THE HEDGING TRADING STRATEGY

An event trading strategy popular among forex traders located outside of the United States - where this sort of trade is no longer available to retail traders - involves taking both a long and short position on the same currency pair to establish a hedge for the event's release.

The two positions should both remain open without cancelling each other out, and they can be established just before the release of a significant economic number or other key news event.

Once the event occurs, the hedged position could be "legged" out of by taking a profit on one side and subsequently waiting for the losing side to appreciate in value as the market corrects, since it often snaps back like a rubber band after the market's strong initial reaction.

This technique could be used by a savvy trader to make a profit on both sides of their hedged position, depending on the range of the moves seen after the event and the quality of the trader's judgment.

The disadvantage of this type of hedged positioning is that the retail forex trader must pay away two spreads to initiate what is in essence a flat or hedged position. The chief advantage of the hedge trade is that the neutral position is impervious to the sharp market swings that generally take place after a significant market event occurs.

THE MOMENTUM TRADING STRATEGY

Momentum trading typically consists of a using one or more technical forex analysis indicators to determine the strength of directional impulses in the forex market and then positioning themselves to follow such impulses until the trend's momentum wanes. So-called momentum indicators help the trader to identify optimal entry and exit points to initiate and liquidate trades.

Some momentum traders might use an exponential moving average or EMA as a technical indicator to generate trading signals. This type of moving average is still a lagging indicator like regular moving averages, but its exponential nature allows it to respond more quickly to trend reversals. This allows the trader to gauge the inertia in the market and to identify up and down trends as the currency pair fluctuates.

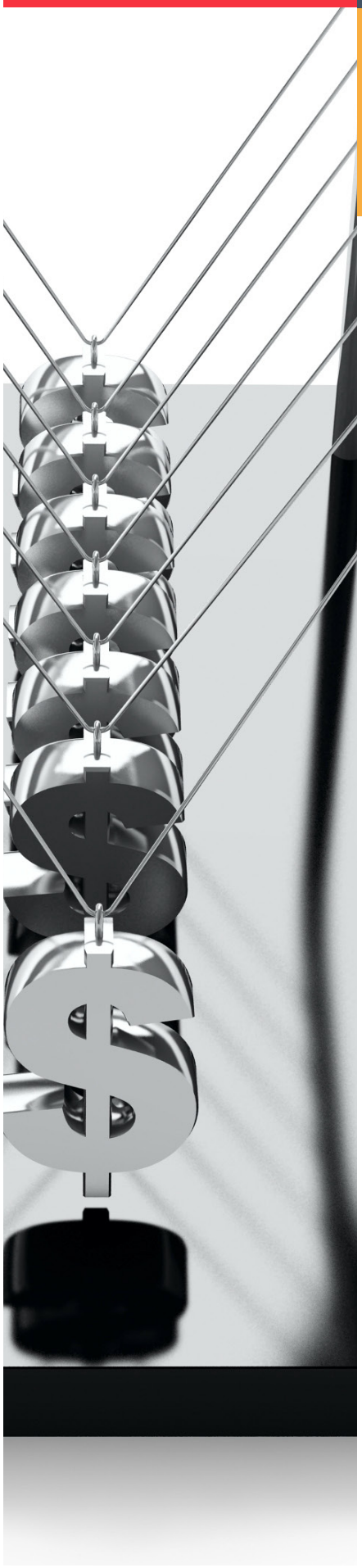
Another popular momentum trading indicator is known as the MACD or Moving Average Convergence Divergence histogram. The slope of the MACD's unbounded oscillating histogram reflects whether the market has a predominance of buyers or sellers in the market. A rising MACD slope would indicate more buyers, while a downward MACD slope indicates a majority of sellers in the market.

The MACD also includes a signal line, which is a smoothed moving average of the MACD histogram that generates buy or sell signals when it crosses over the histogram. For example, a long position entry signal could be generated when the histogram rises above the signal line, while that position would be closed out when the histogram falls below the signal line.

THE MOMENTUM TRADING STRATEGY

The MACD histogram crossing up above its central line could also be a buy signal, while a sell signal would result from it crossing down below that zero line.

For momentum trading, the time frame of the MACD indicator - including the variables for the exponential moving average signal line and the MACD histogram - should be consistent with the trader's objectives and the specifics of their particular trading plan.



THE SWING TRADING STRATEGY

The popular forex trading money making saying of "buy low, sell high" makes up the basis for what are commonly known as swing trading strategies. Basically, the objective of a swing trader is to be on the right side of the market, often using technical analysis to establish an opinion on a currency pair.

Forex swing traders generally use technical analysis indicators to determine which exchange rates are high or overbought and which rates are oversold or relatively low. Swing traders often follow trends, but they also look for market extremes to sell into highs or buy at lows when the prevailing trend's momentum is declining.

They might also determine a particular trading range for a currency pair, and trade the swings within it by selling out longs and going short on the high end of the range, and then covering short positions and going long at the low end of the trading range.

An especially popular indicator used by swing traders is the Relative Strength Index or RSI. This indicator signals a swing trader to buy in oversold markets and sell in overbought markets, especially when the indicator shows divergence relative to the exchange rate at extremes. The swing trader can also watch such an indicator to determine a good exit point for the trade.

They might also look over the currency pair's exchange rate chart to find key support and resistance levels to help them set stop loss orders on their positions. Swing traders generally open positions with a time frame of a day or more, but they will generally hold a position open over a shorter time horizon than other trend following traders.

THE TREND TRADING STRATEGY

As the old market saying states, "The trend is your friend". Trend trading is one of the oldest, most popular, and most lucrative longer term trading strategies employed in just about any market. As in swing trading, the trend trader generally uses technical forex analysis to determine the overall trend in a currency pair; however the trend trader generally has a longer time frame for exiting trades. Due to their focus on a longer time horizon, trend traders may also take various forms of fundamental forex analysis into account.

A typical trend trader will first determines the trend for a currency pair by analyzing its exchange rate chart and drawing trend lines between higher highs and higher lows for an uptrend, while a downtrend is identified by lower highs and lower lows.

Breakout points are determined when the currency pair breaks above major resistance levels or trend lines or breaks down below major support points or trend lines.

The trend trader can also overlay moving averages over the exchange rate to find crossovers indicating when the short term trend is changing in relation to a long term trend. Generally, when a moving average of shorter duration or the price crosses over a longer term moving average, this generates a buy signal in a currency pair.

Conversely, if the shorter term moving average falls below the longer term moving average, this tends to generate a sell signal. Trends in currency pairs traded in the forex market are often observed when changes in the underlying business cycle become evident in one economy relative to another. When the business cycle starts to shift, monetary policy of a central bank and interest rates will also have a tendency to be affected.

THE TREND TRADING STRATEGY

Once a trend in a currency pair is positively identified by a trend trader, they can then manage an effective entry strategy. For example, this might involve buying on a pullback in the case of an upward trend or waiting for a rally to short the market in a downward trend.

After their trend following position is established, the trend trader typically rides the position for as long as the trend runs its course. Many trend traders maintain trailing stop losses on their positions in order to protect profits already accumulated from sudden corrections or reactions where exchange rates move in the opposite direction of the prevailing trend.

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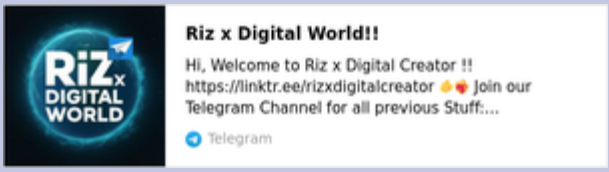

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